S.T.A.R.S. TRANSACTIONS – INTEREST DEDUCTION ALLOWED BUT FOREIGN TAX CREDIT DISALLOWED

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In a partial reversal of the I.R.S. position, a U.S. financial institution was allowed to deduct interest expense on borrowings that formed part of a S.T.A.R.S. transaction in *Salem Financial, Inc. v. United States*.[1] While the Appeals Cout held that the taxpayer could not claim foreign tax credits for the U.K. taxes paid pursuant to the S.T.A.R.S. transaction, it allowed deductions for interest paid on a loan.

Branch Banking & Trust Corporation ("BB&T"), a North Carolina financial holding company, and Barclays Bank PLC ("Barclays"), a U.K. bank were the participants in a financial product transaction BB&T entered into a structured trust advantaged repackaged securities ("S.T.A.R.S.") transaction with Barclays from August 2002 through April 2007. Generally, the economic benefit of a S.T.A.R.S. transaction is to increase yields on investments by affixing an interest expense deduction and a double dip of foreign tax credits to the total return of the investor. Barclays invented the S.T.A.R.S. transaction structure along with the international accounting firm based in the U.K., KPMG L.L.P.

BB&T's S.T.A.R.S. Transaction

The transaction produces tax credits in the U.K. for Barclays and in the U.S. for the U.S. customers by circulating the U.S. income through a U.K. entity, usually a trust. The S.T.A.R.S. transaction that BB&T entered into with Barclays involved the following steps.

- First, BB&T created a trust, for which it appointed a trustee with U.K. tax residence. This caused the trust to be subject to U.K. income tax.
- Nearly $5.77 billion of BB&T's U.S.-based income-generating assets were held in the trust under BB&T's control.
- Barclays then made a loan of $1.5 billion cash to the BB&T trust in exchange for the trust's equity interests, but Barclays was contractually obligated to sell its interests back to BB&T upon completion of the S.T.A.R.S. transaction.
- Barclays made monthly payments to BB&T, which were approximately half of the U.K. tax benefits Barclays received from the trust component.
- The arrangement provide BB&T with the economic benefit of a foreign tax credit for the taxes paid by the trust to the U.K. while deducting the interest payments incurred on the loan with Barclays.

The following example from the case illustrates how the financial product worked in principle based on $100 of Trust income (ignoring fees).

[1] 786 F.3d 932 (Fed. Cir. 2015).

> The Trust income was subject to U.K. taxation at a 22 percent rate. Therefore, $22 for every $100 of Trust income was set aside for payment of the U.K. taxes, leaving the Trust with $78 after the U.K. tax payment. Because of its nominal equity interest in the Trust, Barclays was also taxed on the Trust income under U.K. law at a corporate tax rate of 30 percent, or $30 for every $100 of Trust income. Barclays, however, was able to claim a $22 U.K. tax credit for the $22 of tax paid by the Trust as an "imputation credit" that partially offset the higher corporate tax imposed on the Trust's distributions. As a result, Barclays effectively paid $8 in U.K. tax.
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> The Trust distributed the after-tax amount of $78 of Trust income to the Barclays Blocked Account, from which that sum was immediately re-contributed to the Trust. Under U.K. law, Barclays was able to treat the recontributed $78 as a "trading loss," thereby claiming a trading loss deduction. At the 30 percent tax rate, that deduction was worth $23.40. Barclays' $8 U.K. tax liability was then completely offset by the $23.40 tax deduction, leaving Barclays with a net tax benefit of $15.40.
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> In the example, the Bx payment that Barclays paid to BB&T, which was predetermined to be equal to 51 percent of the Trust's U.K. [pg. 2015-1838] tax payments, would be approximately $11. Barclays would then deduct the $11 Bx payment from its U.K. corporate taxes, which at the 30 percent tax rate yielded another tax benefit worth $3.30. The net benefit to Barclays, for every $100 in Trust income, was thus $7.70, based on U.K. tax credits and deductions (the net tax benefit of $15.40 minus the Bx payment of $11, plus the tax benefit of $3.30 attributable to the deduction for the Bx payment).
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> For its part, BB&T, having paid the $22 U.K. tax on the Trust income, would claim a foreign tax credit of $22 for the entire amount of the Trust's U.K. taxes. However, having received the $11 Bx payment from Barclays, BB&T would have a net gain of $11.
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> The U.K. government effectively collected $3.30 in tax for every $100 of Trust income, because the Trust paid $22 in U.K. taxes while the U.K. government gave back $18.70 in tax benefits to Barclays ($15.40 attributable to the trading loss deduction plus $3.30 attributable to the Bx payment deduction). Based on the structure of the transaction and the amount of the income-generating assets in the Trust, BB&T anticipated receiving approximately $44 million per year from the STARS Trust transaction in addition to the revenue generated by the assets themselves.

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In essence, the transaction appears to be functionally similar to the abuse described in the O.E.C.D. B.E.P.S. action on hybrid mismatch arrangements.[2] The capacity of the S.T.A.R.S. transaction to generate profits for Barclays and BB&T depended both on Barclays' obtaining the expected tax benefits from the U.K. and on BB&T's obtaining the expected foreign tax credits from the U.S. Because of the risks associated

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[2] "Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Law)."

with obtaining those tax benefits, the parties incorporated features that were designed to minimize those risks. The agreement included a "makewhole" provision under which BB&T was obligated to reimburse Barclays if the credits generated by the Trust failed to match the parties' expectations. The parties also agreed to an indemnity provision, which would be triggered if the Trust paid no tax, either because it was not treated as a collective investment scheme under U.K. law or because it was not deemed a U.K. resident. BB&T's indemnity payment to Barclays would be approximately one-half of the U.K. tax that the Trust would have paid. Finally, both parties were entitled to terminate the S.T.A.R.S. transaction for any reason, subject to 30 days' notice.

For its 2002 through 2007 tax returns, BB&T claimed foreign tax credits for the U.K. taxes it paid through the trust and claimed deductions for interest paid on its loan from Barclays. The I.R.S. denied both of BB&T's claims and levied accuracy-related penalties. BB&T paid the tax and filed suit in the Court of Federal Claims for a refund of taxes, interest, and penalties from the I.R.S. The court ruled in favor of the I.R.S. in September 2013.[3] The Court of Federal Claims applied the economic substance doctrine to conclude that the trust and loan components of the S.T.A.R.S. transaction were "economic shams" that lacked economic substance.[4]

BB&T appealed to the U.S. Court of Appeals for the Federal Circuit, which affirmed in part and reversed in part on May 14, 2015. The decision:

- Upheld the accuracy-related penalties on BB&T and disallowed the foreign tax credits,
- Allowed BB&T to deduct the interest expense on the Barclays loan involved in the S.T.A.R.S. transaction, and
- Remanded the case for the reassessment of the penalties for BB&T.

The Court disregarded the trust component of the S.T.A.R.S. transaction because it lacked economic substance, even though it complied in form with U.S. tax law. BB&T argued that the foreign tax complied with a provision of the foreign tax credit regulations which define creditable taxes. Such taxes must not be offset by a rebate or subsidy.[5] The I.R.S. conceded that no subsidy exists. Nonetheless, the Court, citing *Frank Lyon Co. v. United States*[6] and other cases, refused to apply the foreign tax credit regulations without looking at the general economic substance of the transaction. The trust served only to produce foreign tax credits, without any legitimate business purpose.

> What is critical is to identify transactions lacking economic reality, *i.e.*, those that do not alter the taxpayer's economic position in any meaningful way apart from their tax consequences, typically entailing no risk and no significant possibility of profit other than as a result of tax considerations. This is to ensure that tax benefits are available only if "there is a genuine multiple-party transaction with economic

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[3] *Salem Fin., Inc. v. United States*, 112 Fed. Cl. 543 [112 AFTR 2d 2013-6168] (2013).

[4] *Salem Fin., Inc. v. United States*, 112 Fed. Cl. at 588–89.

[5] Treas. Reg. § 1.901-2(e)(3).

[6] 35 U.S. 561 (1978).

> substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels." Frank Lyon, at 583–84. Even if there is some prospect of profit, that is not enough to give a transaction economic substance if the prospect of a non-tax return is grossly disproportionate to the tax benefits that are expected to flow from the transaction. See, *e.g.*, Knetsch v. United States, 364 U.S. 361, 365–66 (1960) (the taxpayer's transaction with the insurance company "was a fiction," because for a claimed interest deduction of $233,297.68, the taxpayer's annual borrowing only kept a net cash value "at the relative pittance of $1,000").

The Appeals Court emphasized that statutory anti-abuse rules will not prevent the common-law economic substance doctrine from being applied to complex transactions. It found that none existed with regard to the foreign tax credit element of the financial product.

> In this case, the trial court's finding that the Trust transaction lacked economic reality was supported by more than just the absence of a prospect for profit. The trial court found that the Trust transaction consisted of "three principal circular cash flows," which, apart from their intended tax consequences, had no real economic effect. 112 Fed. Cl. at 585. Through those circular cash flows, BB&T (1) created an entity that it used to make monthly distributions to the Trust, which the Trust immediately returned to that entity, resulting in subjecting the income to U.K. taxes; (2) caused the Trust to deposit a predetermined amount of funds into a blocked account and then to withdraw those funds immediately, enabling Barclays to claim a U.K. tax loss even though the transaction had no net economic effect; and (3) "cycled tax through the U.K. taxing authority, then to Barclays, and then back to [BB&T]." Id. None of those transactions, the court found, had any economic substance.
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> As explained above, we do not accept the trial court's characterization of the Bx payment as simply a rebate of the Trust's U.K. tax payments; we agree with the trial court, however, that the Trust transaction was a contrived transaction performing no economic or business function other than to generate tax benefits. The trial court correctly concluded that the income "from BB&T's preexisting assets cycled through the STARS Trust was not [economic] profit from STARS," but was akin to the "transfers of income-producing assets to controlled entities that do not imbue an arrangement with substance," because "the transfer has no incremental effect on the taxpayer's activities." 112 Fed. Cl. at 586 (citing cases). As the trial court found, the Trust transaction reflected no meaningful economic activity by BB&T: the incremental profit potential of the Trust (beyond the income already generated by the underlying assets) depended entirely on Barclays' and BB&T's anticipated tax benefits; it exposed BB&T to no economic risk (other than the risk that the IRS would challenge the tax treatment of the transaction); and it had no realistic prospect of producing a profit (apart from the effect of the foreign tax credits).

The Court ruled the loan component of the S.T.A.R.S. transaction had economic substance because "BB&T obtained unrestricted access to $1.5 billion in loan proceeds."

> While it may be true that the Loan operated partly to camouflage the Bx payment, it also resulted in a substantive change in BB&T's economic position. As a result of the Loan transaction, BB&T obtained unrestricted access to $1.5 billion in loan proceeds. An impact of that sort cannot be said to have resulted in no change in the economic benefits enjoyed by the taxpayer. See *Coltec*, 454 F.3d at 1355 ("[T]ransactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration."); *Kerman*, 713 F.3d at 865 (noting that the taxpayer did not have unfettered access to all the loan proceeds under the sham transaction).
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> Obtaining financing of that magnitude, in and of itself, would "appreciably affect" the beneficial interest of a commercial bank such as BB&T. See *ACM P'ship*, 157 F.3d at 261–62 (allowing deduction of economic losses that were "separate and distinct from the $87 million tax loss that did not correspond to any actual economic loss"); *Lee*, 155 F.3d at 586 (reciting the "undoubted proposition that interest on loans incurred to support an economically substantive investment is not disqualified as a deduction merely because the borrower is also motivated by favorable tax consequences"); *Rice's Toyota World*, 752 F.2d at 95–96 ("[I]t does not follow that the sham nature of the underlying transaction supports the Tax Court's conclusion that the recourse note debt was not genuine.... [A] sham transaction may contain elements whose form reflects economic substance and whose normal tax consequences may not therefore be disregarded."); *Coors*, 572 F.2d at 835 ("Since plaintiffs received insurance coverage of this magnitude during the years in issue, it is hard to accept defendant's repeated assertion that plaintiffs during those years received nothing of substance from the various policy advances or loans except a purported interest deduction.").

"This decision comes at a critical time, as many S.T.A.R.S. cases involving U.S. financial institutions have been deferred pending the decision in BB&T."

Thus, BB&T was allowed to deduct the loan interest payments it made to Barclays. The only remaining issue in BB&T's S.T.A.R.S. dispute is the amount of accuracy-related penalties to be imposed upon BB&T.

This decision comes at a critical time, as many S.T.A.R.S. cases involving U.S. financial institutions have been deferred pending the decision in BB&T. For example, Bank of New York Mellon has appealed the disallowance of its 2013 loss in the Tax Court to the Second Circuit Court of Appeals in a S.T.A.R.S. transaction with Barclays. American International Group, Inc. ("AIG") has also appealed the disallowance of its claimed foreign tax credits in a transaction. Wells Fargo and Bank Santander are among the banks in the midst of S.T.A.R.S. disputes before U.S. courts. The critical decision is whether the I.R.S. will accept the B.B.&T decision by the Federal Circuit Court of Appeals as controlling on the other cases or whether it will continue to litigate, hoping to obtain a conflict in the circuit courts of appeals so that the matter can be presented to the U.S. Supreme Court.